Federal Policy for Reimbursement of the Indirect Costs of Research:
A Primer

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What are indirect costs?

- For convenience, expenses of federally funded research are tracked and paid in two separate categories:
  - Goods and services that are specific to individual projects, such as faculty salaries, RA stipends, and equipment. Known as direct or project costs.
  - Goods and services that support multiple projects, such as utilities, depreciation of buildings and equipment, and hazardous waste management, among others. Known as indirect costs or administrative and facilities-related costs.
Are indirect costs significant?

- Indirect costs account for 30 percent of the $23 billion of federal research funds spent by colleges and universities.

- Include $600 million in payments for depreciation of buildings – possibly the largest single source of federal funds for capital projects.

- Direct and indirect costs are both essential components of research support.
Each institution negotiates an indirect cost rate.

- Faculty negotiate the direct costs through the application process with the funding agency.
- In contrast, each institution negotiates a rate that applies to most federally sponsored research.
- Rate agreements are typically in effect for three years, and the rate is fixed for the term.
Rate is expressed as a percentage of direct costs.

- The reimbursement rate for indirect costs is expressed as a percentage of direct costs. According to RAND, the highest rate in 1999 was 75 percent; the lowest was 35 percent. The average was 50 percent.

- COGR reported that the average rate among private universities in 2001 was 57 percent. The average for public universities was 48 percent.

- RAND reported that rates were stable between 1988 and 1999.
Institutions are assigned a “cognizant agency.”

- Each institution negotiates with a “cognizant agency” – either HHS or ONR. Cognizant agencies are assigned based on the institution’s mix of research.

- HHS is the cognizant agency for the majority of institutions.

- HHS conducts true negotiations – but appears to start with targets in mind. ONR relies on a data-driven process.
Do all sponsors pay the federal rate?

- Most, but not all, federal agencies reimburse institutions at the negotiated rate.

- Agriculture provides only 19 percent of direct costs.

- The National Institutes of Health provides 8 percent for Career awards and research training grants.
What guidelines apply to reimbursement?

- OMB’s Circular A-21 sets out guidelines for direct and indirect costs incurred by colleges and universities.

- Circular A-21 establishes three fundamental criteria:
  - Costs must be allowable. (No hookers or booze.)
  - Costs must be reasonable. (No gilded chandeliers, please.)
  - Costs must be allocable to federal sponsors. (Other sponsors should bear their fair share.)
Functions and pools.

- Circular A-21 directs universities to allocate direct costs to one of four major functions of the institution:
  - Organized research
  - Instruction
  - Other sponsored activity (such as community service programs)
  - Other institutional activity (such as residential colleges or athletics)
A-21 also stipulates that indirect costs be accumulated for accounting purposes in seven indirect cost pools:

- General administration
- Departmental administration
- Grant and contract administration
- Student services
- Depreciation
- Operations and maintenance
- Libraries
Indirect costs are then allocated to functions.

- Gen'l Admin.
- Dep't Admin.
- Grant & Contract
- Student Services
- Depreciation
- Operation and Maint.
- Libraries

Indirect costs are allocated to functions

- Organized Rsch
- Instruction
- Other Sponsored
- Other Institutional
Administrative pools

- General Administration – general executive and administrative offices, including, among others, the president or chancellor, provost, finance, general counsel.

  - These costs are prorated among the four functions (organized research, instruction, etc.) on the basis of modified total direct costs allocated to each function.

  - Modified total direct costs are a subset of direct costs. They exclude, among other expenses, the cost of equipment, capital expenditures, and subcontracts over $25,000.
Administrative pools

- Departmental Administration – administrative offices of schools, deans, academic departments, and research centers.
  - A-21 calls for prorating these costs on the basis of modified total direct costs allocated to each function of the university.
  - Cost of faculty effort is capped at 3.6 percentage points.
Administrative pools

- Grant and Contract Administration – expenses of offices established primarily to administer grants and contracts.

  - Costs are prorated among organized research, instruction, and other sponsored activities on the basis of modified total direct cost assigned to each function.
Administrative pools

- Student Administration and Services – Deans of Students, admissions, registrar, and student health and infirmary services.

  - In the absence of a special accounting study, all of these costs are allocated to instruction.
Administrative pools

- Expanded federal requirements for safety and oversight of research are driving administrative costs upward.

- In total, administrative pools may not exceed 26 percentage points of the rate. COGR estimates that the median of actual costs is 28.1 percentage points.
Facilities-related pools

- Depreciation – cost of depreciation of buildings and equipment.
  - Some institutions negotiate depreciation schedules for plant and equipment. Others take the use allowance – 2 percent of acquisition cost.
Facilities-related pools

- Plant operation and Maintenance – utilities, hazardous waste disposal, and interest on debt incurred for capital projects.

  - Costs are allocated on the basis of square footage.

  - Revisions adopted in 1998 “grandfathered” 61 universities that had negotiated higher reimbursement of utilities costs. Those 61 institutions receive an additional 1.3 percentage points in their rate. The Office of Management and Budget promised – but has not met its promise – to allow other schools to seek an adjustment.
Facilities-related pools

- Libraries – cost of acquisitions and operation.
  - Prorated according to the number of students, faculty, staff, and other users.
  - Amounts attributed to students and others is allocated to instruction or “other activities,” respectively.
  - Amounts attributed to faculty and staff are allocated in proportion to salaries and wages allocated to four functions.
An Example

Suppose that the allocation of indirect cost pools to functions turns out to be:

<table>
<thead>
<tr>
<th>Indirect Cost Pools</th>
<th>Org Research</th>
<th>Instruction</th>
<th>Other Spons.</th>
<th>Other Inst.</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Admin.</td>
<td>29 %</td>
<td>33 %</td>
<td>5 %</td>
<td>33 %</td>
<td>100 %</td>
</tr>
<tr>
<td>Grant &amp; Contract Admin.</td>
<td>84</td>
<td>3</td>
<td>13</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Student Services</td>
<td>4</td>
<td>96</td>
<td>0</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Departmental Admin.</td>
<td>30</td>
<td>25</td>
<td>12</td>
<td>33</td>
<td>100</td>
</tr>
<tr>
<td>Library</td>
<td>11</td>
<td>71</td>
<td>2</td>
<td>17</td>
<td>100</td>
</tr>
<tr>
<td>Operations &amp; Maint.</td>
<td>43</td>
<td>22</td>
<td>*</td>
<td>36</td>
<td>100</td>
</tr>
<tr>
<td>Depreciation</td>
<td>41</td>
<td>24</td>
<td>*</td>
<td>35</td>
<td>100</td>
</tr>
</tbody>
</table>
Completing the example

- Which translates into a proposed reimbursement rate of nearly 67 percent.

<table>
<thead>
<tr>
<th>Indirect Cost Pools</th>
<th>Costs Allocated To Org. Rsch (col 1)</th>
<th>Direct Costs (col 2)</th>
<th>Rate (col 1/col 2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Administration</td>
<td>$5.1</td>
<td>$124.7</td>
<td>4.1 %</td>
</tr>
<tr>
<td>Grant &amp; Contract Admin.</td>
<td>3.5</td>
<td>124.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Student Services</td>
<td>0.2</td>
<td>124.7</td>
<td>0.1</td>
</tr>
<tr>
<td>Departmental Admin.</td>
<td>20.5</td>
<td>124.7</td>
<td>16.4</td>
</tr>
<tr>
<td>Library</td>
<td>5.0</td>
<td>121.5</td>
<td>4.2</td>
</tr>
<tr>
<td>Operations &amp; Maintenance</td>
<td>31.2</td>
<td>105.7</td>
<td>29.5</td>
</tr>
<tr>
<td>Depreciation</td>
<td>10.4</td>
<td>105.7</td>
<td>9.8</td>
</tr>
<tr>
<td>Total</td>
<td>75.8</td>
<td></td>
<td>66.9 %</td>
</tr>
</tbody>
</table>
Comparison to Other Performers

- In 1996 the (late) Arthur Andersen compared overhead expenses of seven universities, 13 companies, and 13 federal laboratories. It found that universities are not “top-heavy” with administrative or facilities-related costs.

<table>
<thead>
<tr>
<th></th>
<th>Nat’l Labs</th>
<th>Universities</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Charges</td>
<td>67 %</td>
<td>69 %</td>
<td>64 %</td>
</tr>
<tr>
<td>Admin. Costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Departmental</td>
<td>7</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>Central</td>
<td>13</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>Facilities Costs</td>
<td>13</td>
<td>18</td>
<td>21</td>
</tr>
<tr>
<td>Subtotal, Admin. &amp; Facilities</td>
<td>33</td>
<td>31</td>
<td>36</td>
</tr>
<tr>
<td>Total Costs of Research</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Breakdown of Total Costs of Research
Outstanding issues

- Negotiated rates almost never match rates proposed by universities. Negotiators for cognizant agencies are skeptical and like to save money.

- In practice universities do not recover costs at the negotiated rate. RAND reported, using COGR data, that
  - In practice universities recover only 35 to 45 percent of costs incurred, even though negotiated rates range from about 45 percent to 70 percent.
  - Effective rate is about 10 percentage points below negotiated rates for school with low rates. The difference is as large as 30 percentage points for schools with the highest negotiated rates.
Outstanding issues

- The Office of Management and Budget has not revisited the special adjustment for utility costs. OMB now maintains that any change must be cost-neutral.

Actual administrative costs are above the cap, which took effect in 1993. COGR estimates that universities were unable to recover $200 million in administrative costs in fiscal year 2000.

COGR also reports that heightened demand for more compliance activities will prompt additional spending that will not be recovered. COGR projects that the incremental losses could be as much as $4 million per school in fiscal year 2005.